In the Supreme Court of the United States

OCTOBER TERM, 1973

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

CHEF FOODS, INC. AND YOUR HOST BAKERY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in these cases, but only if the Court grants the petition for a writ of certiorari in No. 73–1652.

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Appendix A, *infra,* pp. 5–40) are reported at 58 T.C. 10. The opinion of the court appeals (Appendix B, *infra,* pp. 41–55) is reported at 489 F. 2d 957.

JURISDICTION

The judgment of the court of appeals (Appendix C, *infra,* pp. 56–57) was entered on December 11, 1973. By

539-270—74——1

order dated March 4, 1974, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to and including May 10, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether additional corporate surtax exemptions under Section 11(d) of the Internal Revenue Code of 1954 claimed by respondent corporations should be disallowed under Section 269(a) of the Code, on the ground that respondents were formed and acquired for the principal purpose of securing the benefits of the surtax exemptions.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 11. Tax imposed.

* * * * *

(d) [as amended by Sec. 121, Revenue Act of 1964, P.L. 88-272, 78 Stat. 25] *Surtax Exemption.*—For purposes of this subtitle, the surtax exemption for any taxable year is $25,000, except that, with respect to a corporation to which section 1561 or 1564 (relating to surtax exemptions in case of certain controlled corporations) applies for the taxable year, the surtax exemption for the taxable year is the amount determined under such section.

* * * * *

SEC. 269. Acquisitions made to evade or avoid income tax.

(a) *In General.*—If—

(1) any person or persons acquire, or acquired, on or after October 8, 1940, directly or indirectly control of a corporation, or

(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

* * * * *

STATEMENT

Respondent corporations were among those in a group of interrelated corporations through which a chain of restaurants, and related activities, were operated in the Buffalo, New York area. Pursuant to Section 482 of the Internal Revenue Code, the Commissioner reallocated income for the years 1965-1968 among these corporations, allocating to other members of the corporate group all of the income reported by the respondents. As an alternative position, in the event the income in question was determined to be properly that of the respondents, the Commissioner disallowed under Section 269 of the Code the surtax exemptions claimed by respondents. This resulted in

the determination of deficiencies against respondents of approximately $40,000 (Appendix A, *infra*, pp. 7–8).

The Tax Court sustained the Commissioner's reallocation of all of respondents' income to the other corporations. As a result, there was no occasion for it to reach the Commissioner's alternative contention against respondents (Appendix A, *infra*, p. 36). On appeal of the decision of the Tax Court by the corporations to which the income of respondents was reallocated, the Commissioner cross appealed to preserve his alternative position against respondents in order to protect the revenue. The court of appeals affirmed the decision of the Tax Court and similarly did not reach the Commissioner's alternative contention (Appendix B, *infra*, p. 45 n. 6).

REASON FOR GRANTING THE WRIT

The corporations to which the income originally reported by respondents have filed a petition for a writ of certiorari. *Your Host, Inc.* v. *Commissioner*, No. 73–1652. Should the Court grant that petition, it should also grant the present petition. This is necessary to preserve the Commissioner's alternative position if the Court should reverse the judgment of the court of appeals in No. 73–1652.

CONCLUSION

The petition for a writ of certiorari should be granted, but only if the Court grants the petition in No. 73–1652.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

MAY 1973.

APPENDIX A

58 T.C. No. 2

United States Tax Court

YOUR HOST, INC., ET AL.,[1] PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Dockets Nos. 2673–69, 2675–69 through 2688–69, 446–70, 448–70 through 461–70, and 1194–71 through 1207–71

Filed April 6, 1972

(1) Your Host, Inc., was formed in 1947 by Wesson and Durrenberger to operate four Your Host Restaurants. Between 1948 and 1956 ten more corporations were formed to operate Your Host Restaurants. In 1969 there were 40 Your Host Restaurants of which Your Host operated 15 with each of the other restaurant corporations operating four or fewer locations. In addition to Your Host and the ten restaurant corporations, Wesson and Durrenberger formed a commissary corporation in 1947, a real estate holding corporation in 1951, and a bakery corporation in 1955. Following Wesson's death Durrenberger formed a vending machine corporation in 1958.

[1] Cases of the following petitioners are consolidated herewith: *Alro Realty, Inc.*, dockets Nos. 2675–69, 461–70, and 1207–71; *Boulevard Host, Inc.*, dockets Nos. 2676–69, 448–70, and 1197–

All of the Your Host Restaurants were similar in appearance, served the same menu, and were open for business 24 hours a day. The restaurants projected an image to the public of being under the same management. Although the 15 corporations together comprised an integrated business entity, each paid the salaries of its own employees and the insurance and utility expenses for its locations. Each corporation was solely responsible for payment of the rent for its locations. Each corporation paid a portion of the salary of Durrenberger, and each paid a fair share of the costs of management, administration, advertising, and maintenance for the whole enterprise.

Held: Respondent abused his discretion in allocating all of the income and deductions of the ten restaurant corporations to Your Host under section 482;

Held, further: Respondent did not abuse his discretion in allocating all of the income and deductions of the bakery corporation to Sher-Del and vending machine corporation to Your Host under section 482 where these corporations did business only with related corporations and where the dealings between the corporations were not at arm's length.

(2) *Held, further.* The principal purpose for the formation of four of the restaurant corporations and

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71; *Chef Foods, Inc.*, dockets Nos. 2677–69, 449–70, and 1198–71. *Main Host Inc.*, dockets Nos. 2678–69, 450–70, and 1199–71: *Niagara Host, Inc.*, dockets Nos. 2679–69, 451–70, and 1200–71: *Rochester Host, Inc.*, dockets Nos. 2680–69 and 452–70. *Royal Host, Inc.*, dockets Nos. 2681–69, 453–70, and 1201–71; *Sharlem Host, Inc.*, dockets Nos. 2682–69, 454–70, and 1202–71; *Telesnax, Incorporated*, dockets Nos. 2683–69, 455–70, and 1203–71; 309 *Delaware Ave., Inc.*, dockets Nos. 2684–69, 456–70, and 1206–71: *Transit Host, Inc.*, dockets Nos. 2685–69, 457–70, and 1205–71: *Utica Host, Inc.*, dockets Nos. 2686–69, 458–70, and 1204–71: *Sher-Del Foods, Inc.*, dockets Nos. 2687–69, 459–70, and 1195–71; and *Your Host Bakery, Inc.*, dockets Nos. 2688–69, 460–70, and 1196–71.

the real estate holding corporation was tax avoidance; therefore, respondent's disallowance of the surtax exemptions of these corporations under section 269 was correct.

Ralph J. Gregg and *George M. Zimmerman,* for the petitioners.

Stephen M. Miller for the respondent.

IRWIN, *Judge:* Respondent determined the following deficiencies in the corporate income taxes of petitioners:

Petitioner	Docket No.	Year	Deficiency	
			Sec. 482	Sec. 531
Your Host, Inc.	2673-69	1965	$154,584.85	$93,040.86
		1966	173,381.44	98,958.31
	446-70	1967	170,930.11	94,399.00
	1194-71	1968	170,198.45	93,000.00
Alro Realty, Inc.	2675-69	1965	3,541.84	
		1966	2,791.52	
	461-70	1967	2,661.32	
	1207-71	1968	2,621.00	
Boulevard Host, Inc.	2676-69	1965	5,031.30	
		1966	5,000.08	
	448-70	1967	4,795.04	
	1197-71	1968	5,500.00	
Chef Foods, Inc.	2677-69	1965	5,000.04	
		1966	5,000.36	
	449-70	1967	4,999.96	
	1198-71	1968	5,500.00	
Main Host, Inc.	2678-69	1965	3,245.88	
		1966	4,999.40	
	450-70	1967	5,000.44	
	1199-71	1968	5,500.00	
Niagara Host, Inc.	2679-69	1965	5,000.08	
		1966	5,000.08	
	451-70	1967	4,999.84	
	1200-71	1968	5,500.00	

Petitioner	Docket No.	Year	Deficiency	
			Sec. 482	Sec. 531
Rochester Host, Inc	2680–69	1965	$2, 338. 84	
		1966	489. 56	
	452–70	1967	216. 36	
Royal Host, Inc	2681–69	1965	5, 000. 12	
		1966	5, 000. 76	
	453–70	1967	5, 000. 36	
	1201–71	1968	5, 500. 00	
Sharlem Host, Inc	2682–69	1965	4, 999. 96	
		1966	5, 000. 36	
	454–70	1967	5, 000. 04	
	1202–71	1968	5, 500. 00	
Telesnax, Inc	2683–69	1965	4, 279. 32	
		1966	4, 904. 76	
	455–70	1967	4, 494. 32	
	1203–71	1968	4, 933. 00	
309 Delaware Ave., Inc	2684–69	1965	4, 999. 80	
		1966	5, 000. 32	
	456–70	1967	4, 999. 68	
	1206–71	1968	5, 501. 00	
Transit Host, Inc	2685–69	1965	4, 999. 96	
		1966	5, 000. 16	
	457–70	1967	4, 773. 68	
	1205–71	1968	3, 653. 00	
Utica Host, Inc	2686–69	1965	5, 000. 36	
		1966	4, 690. 48	
	458–70	1967	4, 083. 69	
	1204–71	1968	5, 501. 00	
Sher-Del Foods, Inc	2687–69	1965	15, 250. 86	$14, 175. 28
		1966	19, 998. 48	21, 377. 40
	459–70	1967	19, 087. 40	28, 709. 00
	1195–71	1968	21, 509. 43	18, 115 00
Your Host Bakery, Inc	2688–69	1965	5, 000. 08	
		1966	5, 045. 36	
	460–70	1967	5, 000. 00	
	1196–71	1968	5, 500. 00	

Respondent has conceded that petitioners Your Host, Inc., and Sher-Del Foods, Inc., are not subject to the accumulated earnings tax imposed by section 531 [2] for the years in question. After other concessions the following issues remain for decision:

(1) Whether respondent was arbitrary in allocating under section 482 all of the income and deductions of the ten corporations operating restaurants and the vending machine corporation to Your Host, Inc.; and

(2) In the alternative to the first issue, whether the surtax exemptions provided by section 11(d) should be disallowed under section 269 in the cases of these 11 corporations; and

(3) Whether respondent was arbitrary in allocating under section 482 all of the income and deductions of Your Host Bakery, Inc., to Sher-Del Foods, Inc.; and

(4) In the alternative to the third issue, whether the surtax exemptions of Your Host Bakery, Inc., and Alro Realty, Inc., should be disallowed under section 269; and

(5) Whether as an alternative to proceeding under section 269 the surtax exemption of Alro Realty, Inc., should be disallowed under section 1551.

We need not consider the second issue if the first issue is found in respondent's favor, nor the fourth issue if the third is found in respondent's favor. Similarly, there will be no deficiencies against the restaurant corporations if we uphold respondent on the first issue and no deficiency against Your Host Bakery, Inc., if we uphold respondent on the third issue.

[2] All statutory references are to the Internal Revenue Code of 1954, as amended.

Finding of Fact

Some of the facts have been stipulated and they are so found. The exhibits attached to the stipulation are incorporated herein by this reference.

All of the petitioners herein are corporations chartered under the laws of the State of New York. For each of the years in question petitioners filed their Federal income tax returns with the district director of internal revenue, Buffalo, N.Y. During the years in issue the business address and principal place of business of petitioners was 3491 Delaware Avenue, Kenmore, N.Y.

The founders, principal stockholders and officers of all of the corporations involved herein were Alfred J. Durrenberger, Jr. (Durrenbeger) and Ross T. Wesson (Wesson). Wesson was killed in an airplane crash on July 17, 1956, and Durrenberger died on October 28, 1968. Wesson and Durrenberger will in some instances be referred to as the partners.

Before going into business together in 1944, Durrenberger had been a butcher and the owner of a retail meat market in the village of Kenmore, N.Y., and Wesson had run a diner in the village of Gowanda, N.Y. On May 1, 1944, Wesson and Durrenberger filed a certificate in the office of the Clerk of Erie County that they were conducting business under the assumed name and style of "Your Host," giving their business address at 461 Kenmore Avenue, Kenmore, N.Y., and thereupon proceeded to open a hot dog stand at that location. In 1946 they purchased the land on which the hot dog stand was located.

In December 1944, Wesson and Durrenberger leased property at 2835 Delaware Avenue, Kenmore, N.Y., next to Durrenberger's meat market, made leasehold improvements therein, and opened their first restaurant, known as Your Host Restaurant.

In 1945 Wesson and Durrenberger opened two more restaurants in the Buffalo area. These restaurants were all similar in appearance, operation, and menu and each operated under the name of Your Host Restaurant.

Your Host, Inc. (hereinafter Your Host) was incorporated and commenced business on January 1, 1947, with Durrenberger and Wesson as equal stockholders. They transferred to it the business assets and liabilities they had acquired as a partnership, including the leasehold improvements at the three restaurants and the hot dog stand, for promissory notes totalling $62,518.15 and 100 shares of the common stock of the par value of $100 per share.

On March 20, 1947, Wesson and Durrenberger purchased lots on Delaware Avenue in the town of Tonawanda, N.Y., (now known as 3491 Delaware Avenue), upon which was located a one-story cement block building intended to be used as a commissary. They thereupon incorporated Sher-Del Foods, Inc. (hereinafter Sher-Del) to operate a food processing plant and commissary, and it commenced business on September 1, 1947. They transferred to it the property which they had bought at 3491 Delaware Avenue and other current and fixed assets for promissory notes totalling $43,400 and 100 shares of common stock of the par value of $100 per share. Sher-Del assumed Durrenberger's and Wesson's individual liabilities with respect to 3491 Delaware Avenue upon said transfer, and repaid the $43,400 promissory notes in the middle 1950's.

In 1947 Your Host opened two additional restaurants upon leased premises. These restaurants were similar in appearance, operation, and menu to the restaurants previously in business and each operated under the name of Your Host Restaurant.

On April 20, 1948, Wesson and Durrenberger, doing business as "Your Host" leased the premises at 309 Delaware Avenue, Buffalo, N.Y. The lease agreement required that the tenants operate a restaurant under the name of and in the manner of existing Your Host Restaurants. The lease further permitted the tenants to assign the lease to a corporation organized by them at which time their personal obligation for the rent would cease.

The prospects for a restaurant at 309 Delaware Avenue were not as favorable as those enjoyed at the other Your Host locations. The rent was higher there than for other locations ($250 to $300 per month over a seven-year period compared to a $200 maximum per month on a ten-year lease at 3232 Bailey Avenue). There were no adjacent parking facilities, and pedestrian traffic was not as heavy as at other locations. In light of these factors the attorney for Wesson, Durrenberger, and Your Host, F. Paul Norton (Norton), recommended that the restaurant at 309 Delaware Avenue be incorporated separately.

On June 9, 1948, Wesson and Durrenberger incorporated 309 Delaware Avenue, Inc. (hereafter 309 Delaware) as equal shareholders. Subsequently, 309 Delaware began operation of a Your Host Restaurant at 309 Delaware Avenue and became the assignee of the lease for those premises.

During the period from 1951 to 1954 Wesson and Durrenberger caused three more corporations to be formed to operate Your Host Restaurants. These corporations were Royal Host, Inc. (Royal), Telesnax, Inc. (Telesnax), and Utica Host, Inc. (Utica). The circumstance surrounding their incorporation are summarized below:

1. TELESNAX

Wesson and Durrenberger set up Telesnax with two principal ideas in mind. First, they desired to give their accountant, James L. Clements, an opportunity to obtain a proprietary interest in the success of Your Host Restaurants. Second, they desired to take advantage of the burgeoning popularity of television by offering viewers an opportunity to order meals on the telephone that would be delivered to their homes. The name Telesnax was designed to convey this second purpose to the public, and by using Telesnax as a corporate name they felt that they could prevent its appropriation by another operation.

Clements did in fact obtain one-third of the stock of Telesnax; however, the meals-at-home idea was never developed and no attempt was made to obtain trademark protection for the Telesnax name. Instead of using Telesnax to develop the meals-at-home idea, Durrenberger felt it advisable to use the new corporation to operate a Your Host Restaurant in some empty store space next to a supermarket. This restaurant was opened for business in 1951.

2. ROYAL HOST

No particularly compelling reason was offered at trial for the formation of Royal Host in 1951 by Wesson and Durrenberger. Clements testified that there was concern that there would be infringement upon the Your Host name by other businesses using a similar name. Consequently, the partners filed an application for incorporation under the name of The Host, Inc. This application was rejected because of its similarity to The Host, Incorporated, an already existing corporation. Incorporation of Royal Host and other corporations whose names included the word Host was seen as offering some protection for the

Your Host business. The subsequent use of the Royal Host name by Wesson and Durrenberger is noted in the margin.[3]

Royal Host commenced operating a Your Host Restaurant in 1951 on leased premises.

3. UTICA HOST

Wesson and Durrenberger formed Utica Host in September 1954 to operate a Your Host Restaurant upon leased premises upon which a former tenant had operated a restaurant. This restaurant had failed and the landlord had become the owner of the restaurant assets. The former restaurant had a record of a small sales volume, was poorly designed, and was located in a "changing neighborhood." In light of these factors the partners decided the restaurant was a risky venture and should be separately incorporated.

Prior to 1953 all of the Your Host Restaurants except one were located in downtown commercial areas or in residential areas; however, in 1953 Wesson and Durrenberger became interested in placing restaurants in large suburban shopping plazas. At that time the development of large suburban shopping plazas was in its early stages. Norton recommended against placing Your Host Restaurants in the plazas because

[3] The Your Host Restaurants were very simple establishments emphasizing hamburger sandwiches on their menus. Wesson wanted to open up a fancy restaurant or steak house which served liquor. In 1954 Wesson and Durrenberger formed Air Host, Inc., as equal shareholders. Air Host commenced operating a restaurant of the type desired by Wesson called the Royal Host. Respondent has conceded the cases involving Air Host, Inc., and has not allocated the income and deductions of Air Host to Your Host. These concessions notwithstanding, Air Host will be mentioned in the opinion. It is important to remember that the Royal Host Restaurant was run by Air Host, Inc., and not by Royal Host, Inc., or one of the other "Host" petitioners.

the shopping plaza idea was as yet untried in the Buffalo area, the plazas were not accessible to public transportation, and the onset of the Korean conflict made the availability of private automobiles and gasoline doubtful in his mind. In addition, placing restaurants in the plazas required a lease obligation of a longer term and for greater rent than Your Host had become accustomed to undertake. Because Wesson and Durrenberger felt that the plazas showed promise, Norton advised that each new restaurant be placed in a separate corporation in order to insulate Your Host in the event that the plazas did not live up to the partners' expectations.

During the period from 1953 to 1956 the following four corporations were organized to operate a Your Host Restaurant in a new shopping plaza:

Corporation name (abbreviation)	Shopping plaza	Date incorporated	Year plaza restaurant opened
Boulevard Host, Inc. (Boulevard).	Northtown	June 1953	1953
Niagara Host, Inc. (Niagara)	Marvin Gardens.	February 1955.	1955
Transit Host, Inc. (Transit)	Transitown	May 1955	1956
Sharlem Host, Inc. (Sharlem)	Sheridan-Harlem.	June 1956	1957

Boulevard, Niagara, and Sharlem were each incorporated with Wesson and Durrenberger as equal shareholders. Transit was a wholly-owned subsidiary of Your Host upon its organization. In December 1955 Your Host acquired all of the stock of Niagara, and in February 1957 Your Host acquired all of the stock of Sharlem.

In addition to the above changes in the corporate family tree, Royal acquired all of the stock of Utica in December 1955.

In September 1955 Durrenberger became interested in a location for a Your Host Restaurant near the village of Williamsville. Durrenberger decided to set up a separate corporation to operate a restaurant on this location because he felt that his own resources and those of the other corporations had become overextended with the expansion of the Your Host chain into the shopping plazas. At this time Wesson was occupying himself primarily with running the Royal Host Steak House, fulfilling his duties as an officer in both the local and national restaurant associations, and flying his private airplane. There was no economic reason peculiar to the Williamsville location which indicated the need for a separate corporation.

In September 1955 Main Host, Inc. (Main) was organized by Wesson and Durrenberger and in January 1956 all of its stock was acquired by Royal. During 1956 Main commenced operating a Your Host Restaurant upon the Williamsville location.

In early 1956 Wesson and Durrenberger became interested in developing a chain of Your Host Restaurants in the area of Rochester, N.Y., which is about 70 miles distant. Two of their Buffalo area competitors had tried to penetrate the Rochester area previously without success. The partners anticipated problems stemming from the absentee management of the Rochester operations and were not confident of succeeding in the new area. Accordingly, they organized Rochester Host, Inc. (Rochester), in May 1956 as equal shareholders. After delays caused by the death of Wesson, Rochester opened its first Your Host Restaurant in the Rochester area in the latter part of 1957.

Rochester was the latest corporation formed by the partners to operate Your Host Restaurants; however, new restaurants were added to the chain without creat-

ing any additional corporation. The following chart indicates the development of the Your Host restaurant chain from 1944 to 1969 by showing the names of the corporations and the years in which each first opened a restaurant as well as the latter years in which each corporation opened additional restaurants:

Years in which restaurants were opened

Corporation	1st	2d	3d	4th	5th	6th	7th	8th	9th	10th–15th
Your Host	1944	1944	1945	1945	1947	1947	1958	1959	1960	1969
309 Delaware	1948	1949	1950	1959						
Royal	1951									
Boulevard	1953	1966								
Utica	1954	1958	1964	1968						
Niagara	1955	1960	1964	1965						
Main	1956	1959	1966							
Transit	1956	1960								
Sharlem	1957	1960	1963							
Rochester	1957	1962 [1]	1962 [1]							
Telesmax	1951	1968 [2]								

[1] Terminated business in 1968.
[2] Replaced first restaurant.

The capital needed for the expansion of the Your Host Restaurant chain came primarily from three sources: (1) relatively small capital contributions from either the partners or one of the corporations; (2) substantial open account interest-free cash loans from Your Host, Sher-Del Foods or one of the other restaurant corporations; and (3) credit from Sher-Del for supplies used during the first few weeks of a new restaurant's business.

In all cases the corporations were only responsible for the rent payments on the premises on which they actually operated restaurants. In any case in which Wesson and Durrenberger, Your Host, or one of the restaurant corporations negotiated a lease for a new restaurant location the lease contained provisions permitting its transfer to another corporation without any liability on the part of the initial lessee. Ap-

parently the lease between Wesson and Durrenberger and the landlord of 309 Delaware Avenue entered into in 1948 served as a model for all subsequent leases for Your Host Restaurants.

In 1947 Wesson and Durrenberger incorporated Sher-Del Foods, Inc., to operate a food processing plant and commissary. The Your Host Restaurants were only able to buy meat and other supplies at retail prices; therefore, it was necessary to establish Sher-Del as a bona fide independent food wholesaler so that it could take advantage of the wholesale prices available to such concerns. The Your Host Restaurants buy all of their supplies from Sher-Del on an open account basis; however, 30 percent of Sher-Del's business on the average is with outside customers. The prices charged Your Host Restaurants and outsiders are the same.

Initially Sher-Del operated the commissary business in a one-story building located at 3491 Delaware Avenue, Tonawanda, N.Y. Wesson and Durrenberger had purchased this building and nine lots at this address in 1947 and contributed them to Sher-Del. In 1948 and 1949 Sher-Del bought four lots adjoining the commissary, began to develop the property as a business block, and added store front space. In 1950 Sher-Del improved and enlarged its commissary operation upon this property, and in August 1951 Royal commenced operating a Your Host Restaurant in the store front space.

On October 1, 1951, Sher-Del sold this property to a new corporation formed by Wesson and Durrenberger, Alro Relaty, Inc. (Alro), for $112,822.93 represented by a four percent promissory note.

Alro Realty, Inc., was formed in September 1951 with Wesson and Durrenberger as equal shareholders. The partners believed that they could obtain better mortgage financing if one corporation owned all of

the real estate that at that time was owned by Your Host and Sher-Del. They also hoped to infuse some cash into Sher-Del when Alro paid the $112,822.93 note with which it purchased 3491 Delaware Avenue and adjacent land from Sher-Del. In fact Alro was never particularly profitable and did not reduce the unpaid balance of the note below $110,000; however, Alro did purchase additional land adjacent to 3491 Delaware Avenue until it had acquired an entire city block. Upon this block it developed a small plaza which housed the business offices of all of the related corporations and provided space for unrelated tenants.

In 1955 the partners were presented with an opportunity to purchase a fully equipped bakery for an investment of $15,000 in cash and a mortgage of $18,000. Not only was the purchase price of the bakery favorable, but also the acquisition protected the restaurants from a loss of local supplies of sweet baked goods. A significant portion of the business of the Your Host Restaurants came from the sale of pies, cakes, doughnuts, and other sweet goods, and this business would suffer if an adequate supply of sweet goods could not be maintained.

Although the bakery would have assured purchasers for its products in the Your Host Restaurants, the partners felt that their inexperience in the baking business made the success of the bakery somewhat doubtful and that it would be best to limit the liability of the other businesses to the $15,000 cash investment. Accordingly, Your Host Bakery, Inc. (Bakery) was formed in November 1955 with Wesson and Durrenberger as equal shareholders to operate the bakery.

Bakery was a successful venture. It did not sell any of its products directly to the public or to the restaurants. Sher-Del took orders for baked goods from the restaurants and made purchases from Bakery. The

prices which Sher-Del paid Bakery for baked goods and which the restaurants paid Sher-Del for the same items were identical and were based upon the wholesale price list of a commercial baking corporation.

Chef Foods, Inc. (Chef), was the last corporation to be formed. In 1956 Wesson and Durrenberger began exploring the idea of providing meal catering service in industrial plants. The death of Wesson in 1956 and the expansion of the restaurant business caused Durrenberger to defer the development of the in-plant feeding idea. In 1958 he formed Chef Foods, Inc., to go into the in-plant feeding business; however, this business was never developed. Instead, Chef purchased vending machines in 1959 and 1962. These machines were placed only in Your Host Restaurants. In addition, Chef purchased refrigeration and storage plants located at 2646 Delaware Avenue in 1959. Sher-Del leased from Chef a part of these facilities for use in the commissary business and Chef used the other part for the vending business.

The Your Host Restaurants were all similar in appearance, served identical menus at the same prices, and were open for business 24 hours a day. In their advertising the restaurants tried to convey to the public that each restaurant was a part of a chain with the same management. No attempt was made to convey to the public the separate corporate ownership of some of the restaurants. Solicitations in the newspaper for employees were made in the name of Your Host Restaurants, and letters were sent under the cover "Your Host the Family Restaurants" even though they were signed in the name of individual corporations.

The President of each corporation was Durrenberger from Wesson's death in 1956 until his own death in 1968. Following her husband's death, Durrenberger's widow became the president of each corporation.

As will be explained *infra*, the restaurants shared the same top management personnel. None of the corporations paid Your Host for use of the Your Host Trademark.

Each of the corporations maintained its own minute book; however, the minutes recorded for Your Host were meager while those recorded for the other corporations were nearly non-existent. Each corporation had at least one bank account, and each restaurant maintained a depository account at a bank situated near to it. Deposits representing daily receipts of each restaurant were placed in the respective depository accounts and then transferred on a weekly basis to the bank account of the corporation to which they belonged. Each corporation used its own bank account to pay most of the expenses attributable to the operation of its restaurants. These expenses included supplies purchased from Sher-Del, utility bills, rent, Federal and State income taxes, social security taxes and income taxes withheld from employees, fire insurance, license fees, and sign bonds (where necessary).

Because Your Host could obtain master policies for public liability insurance and workmen's compensation covering all the restaurants and their employees for a cost that was less than the combined cost of separate policies for each corporation, Your Host advanced the premium payment to obtain such master policies. Your Host was then reimbursed by the other corporations for their share of the premium, which was computed by the insurer or its agent according to a formula based upon the payroll of each corporation.

At one time the corporation paid the wages for their employees in cash; however, in 1952 wages began to be paid by check for security reasons. For administrative convenience and to enable the em-

ployees to cash their checks without difficulty, salaries for all employees of every corporation were paid from a special zero-balance payroll account maintained by Your Host. This account worked in the following manner; every week each corporation computed its own net payroll (after deduction for withholding items) and paid this amount into the "Your Host, Inc., Payroll Account"; all wages were then paid from this account leaving a "Zero balance." This payroll account was not carried as an asset upon the books of Your Host.

Each restaurant had its own manager who was generally responsible for the operation of his restaurant. His duties included ordering supplies and hiring and firing employees; however, the manager had no authority to change the menu of the restaurant, change its business hours, or purchase supplies from someone other than Sher-Del. The restaurant managers could not write checks. The managers were compensated on a salary plus bonus arrangement. The amount of the manager's bonus depended upon the success of his location.

The personnel needed to administer and maintain all 16 corporations were nominally the employees of Your Host; however, the expenses attributable to these employees were in fact shared by all of the corporations during the years in issue in the following manner:

(1) With exceptions noted below, the cost of the administrative staff (bookkeepers, typist, clerks, and the like), group insurance premiums, and the expenses of the administrative office were allocated among the corporations according to gross sales;

(2) Advertising costs were allocated among the corporations operating Your Host Restaurants in the Buffalo area according to gross sales;

(3) The cost of the maintenance crew and the salaries of the Your Host Restaurant area supervisors—six or seven men who each oversaw the operations of six or seven restaurants—were allocated among the corporations operating Your Host Restaurants.

The gross sales of Air Host which operated the Royal Host Restaurant were included in the administrative expense allocation at only half of actual sales excluding liquor sales. This adjustment was made to reflect the fact that the Royal Host Restaurant sold liquor and meals which were considerably more expensive than those available in Your Host outlets. The high price of Royal Host meals did not command a proportionately high amount of administrative effort.

The gross sales of Sher-Del were included in the administrative expense allocation at a figure that was less than actual sales to reflect the fact that intercorporate sales did not require a great deal of administrative effort and that Sher-Del employed a small administrative staff on its own. The figure used for gross sales was either one-half actual sales or twice sales to unrelated customers.

Rochester Host was not included in the advertising expense allocation because the Rochester restaurant could not benefit from Buffalo area advertising. It appears from the record that Your Host paid more than its share for advertising under the formula. No explanation can be found for the discrepancy except that Your Host may have paid entirely on its own for certain small advertising items like help-wanted ads.

The corporations not running restaurants and Air Host were allocated no part of the advertising or area supervisor expenses because these items related particularly to the sales of the Your Host Restaurants.

Although Your Host advanced the funds necessary to take care of the administrative, advertising, and supervisory expenses, each of the corporations did in fact pay its allocated share of the expenses. Only the allocable part of the expenses appear on the returns of each corporation.

In all of the years in issue Durrenberger drew part of his salary from each of the corporations. The following chart represents his draw from each corporation:

	1965	1966	1967	1968
Sher-Del Foods, Inc	$22,500	$22,500	$22,500	$18,750
Your Host, Inc	12,600	12,600	11,400	11,400
309 Delaware Ave., Inc	7,800	5,400	4,200	1,500
Royal Host, Inc	1,500	1,000	1,000	833
Telesnax, Inc	1,000	1,000	1,000	833
Boulevard Host, Inc	1,000	1,000	1,000	1,000
Air Host, Inc	1,100	1,000	1,000	833
Utica Host, Inc	1,100	1,500	2,000	1,667
Niagara Host, Inc	1,100	2,000	4,000	3,333
Main Host, Inc	1,100	1,200	2,000	1,667
Transit Host, Inc	1,100	1,200	1,200	1,333
Sharlem Host, Inc	1,100	1,500	2,000	1,667
Rochester Host, Inc	1,100	1,500	1,200	833
Your Host Bakery, Inc	1,000	1,500	1,500	1,333
Alro Realty, Inc	1,000	1,000	1,000	833
Chefs Foods, Inc	1,000	1,500	1,500	1,333
Total	57,100	57,400	58,500	49,148

The fifteen corporations reported the following amounts of taxable income for the year in issue:

	1965	1966	1967	1968
Your Host	$136,702	$107,101	$126,338	$111,310
309 Delaware	47,960	45,859	48,816	38,820
Royal	31,894	35,587	33,107	39,142
Boulevard	25,932	28,596	23,973	27,822
Utica	28,132	23,451	20,420	25,674
Niagara	36,646	58,971	71,358	58,031
Main	16,231	35,680	38,153	50,392
Transit	88,402	36,092	23,866	16,602
Sharlem	29,695	29,607	36,748	30,273
Rochester	11,693	2,447	1,082	(Loss)
Chef	31,098	42,882	41,727	35,760
Telesnax	16,459	18,737	17,284	17,253
Bakery	34,896	44,882	43,390	43,327
Sher-Del	41,212	79,494	158,231	64,816
Alro	17,708	13,799	13,309	11,908

OPINION

In 1944 Wesson and Durrenberger opened the Your Host hot dog sand in Buffalo as a partnership. In the same year they commenced operating the first Your Host Restaurant, a high quality short-order restaurant. Two more Your Host Restaurants were opened in 1945. In 1947 the partners formed Sher-Del to operate a commissary which would supply their restaurants and other customers. Between 1948 and 1956 ten more corporations were formed for various reasons (or for no apparent reason at all) to operate additional Your Host Restaurants. In 1951 the partners placed all of the real estate holdings of Your Host and Sher-Del into a new corporation, Alro, in order to

develop these holdings commercially. In 1955 the partners formed Bakery to operate a bakery which would supply the restaurants with their needs for sweet baked goods. In 1958 Chef was formed to operate vending machines in Your Host Restaurants. No additional corporations were formed after 1958; however, the size of the restaurant chain grew considerably. In 1968 there were 40 Your Host Restaurants of which Your Host operated 15 with each of the ten other restaurant corporations operating four or fewer locations.

After Wesson's death in 1956 all of the corporations except one were either wholly owned by Durrenberger or wholly owned subsidiaries of one of Durrenberger's corporations. Durrenberger was the president of each corporation, and all the corporations shared the same administrative personnel. All of the Your Host Restaurants operated by 11 corporations were similar in appearance, served the same menu, and were open for business 24 hours a day. Through advertising and telephone directory listings the public was given the impression that each Your Host Restaurant was a member of a chain with a single management.

Respondent allocated all of the income and deductions of the ten corporations operating restaurants and the vending machine corporation to Your Host and the income and deductions of Bakery to Sher-Del. In the alternative respondent has disallowed the surtax exemptions of every corporation except Your Host and Sher-Del under either section 269 or section 1551. We are to decide whether respondent's determinations are correct.

The facts of this case have many similarities to those of *Marc's Big Boy-Prospect, Inc.*, 52 T.C. 1073 (1969), affd. F. 2d —— (C.A. 7, 1971), under which respondent believes his allocations under section 482 can be sup-

ported without question. If the present case were the mirror image of *Marc's Big Boy-Prospect, Inc.*—which it is in respondent's view—our task would be much simpler than we now foresee; however, in our view there are several facts which distinguish this case from *Marc's Big Boy-Prospect, Inc.* and which require a result unlike that of the former case. Accordingly, we shall try to place this case within the proper perspective of section 482 and the pertinent cases which deal with section 482.

Section 482 permits the Secretary or his delegate to allocate income and deducations among two or more organizations owned or controlled by the same interests if he determines that such allocation is necessary to prevent evasion of taxes or clearly to reflect the income of such organization. The Commissioner's authority to allocate, though broad, does not permit him to abuse his discretion or be arbitrary, capricious, or unreasonable. The burden is, however, upon petitioner to show that the Commissioner has overstepped his authority. *Marc's Big Boy-Prospect, Inc., supra; Bush Hog Manufacturing Co.*, 42 T.C. 713 (1964). See particularly *Phillip Brothers Chemicals, Inc.* (*N.Y.*) v. *Commissioner*, 435 F. 2d 53 (C.A. 2, 1970), which arises in the circuit in which appeal herein would lie. Despite petitioner's burden, if the Commissioner's allocation does not appear reasonable in light of the record, we must conclude that he abused his discretion. *V. H. Monette & Co.*, 45 T.C. 15, 36–37 (1965).

The parties have approached section 482 as if it dealt with several types of prohibited activity; however, our review of the statute and its legislative and judicial history indicates that section 482 is designed to remedy only one abuse: the shifting of income from one commonly controlled entity to another. *Hamburgers York Road, Inc.*, 41 T.C. 821, 833 (1964);

Ballentine Motor Co. v. *Commissioner*, 321 F. 2d 796 (C.A. 4, 1963), affirming 39 T.C. 348 (1962); H. Rept. No. 2, 70th Cong., 1st Sess., pp. 16–17, 1939 C.B. (Part 2) 395. Tax avoidance motives or the lack of a business purpose in forming several corporations are relevant in a section 482 case only to the extent that they prove that there has been an actual shifting of income from one corporation to another. Section 482 is not designed to punish the mere existence of commonly controlled entities nor the unexercised power to shift income among them. *Grenada Industries, Inc.*, 17 T.C., 231 (1951), affd. 202 F. 2d 873 (C.A. 5, 1953); *Bush Hog Manufacturing Co., supra*, at 37; *W. Braun Co.* v. *Commissioner*, 396 F. 2d 264 (C.A. 2, 1968). Similarly, if there has been an actual shifting of income, purity of purpose and the presence of sound business reasons for forming multiple corporations are no defense under sections 482. In short, section 482 does not deal with motivation and purpose as do section 269 and section 1551 but with economic reality.

Many section 482 cases involve a specific transaction or group of transactions which must be scrutinized for their effect in shifting income from one entity to another; however, it is well settled that the Commissioner can use section 482 to allocate all of the income and deductions of one entity to another where the economic realities so warrant. *Hamburgers York Road, Inc., supra; Marc's Big Boy-Prospect, Inc., supra.*

In *Hamburgers York Road, Inc.*, a successful downtown department store decided to establish a suburban branch store; however, instead of operating the store as a branch the suburban store was incorporated with its ownership related to that of the corporation operating the downtown store. On the record in that case we found that the downtown store provided without

adequate compensation so many services for the suburban store that were essential to the suburban store's economic viability that the income of the suburban store was in fact earned by the downtown store. 41 T.C. at 835–38.

As we noted previously, the facts in *Marc's Big Boy-Prospect, Inc.,* resemble those of the present case in many ways. In the former case, Wisconsin Big Boy WBB) acquired the Big Boy restaurant franchise for the State of Wisconsin. Within a few years it set up or acquired from its shareholders several subsidiary corporations to operate restaurants in the Milwaukee area and two corporations to run commissaries. Each of the subsidiaries operated a restaurant under a subfranchise agreement with WBB. The agreement provided that WBB would supply each subfranchisee with supervisory and management services for a modest sliding-scale percentage-of-profits fee. The subfranchisees also received the right to use the national Big Boy trademark under the agreement. Under the arrangement, WBB was responsible for running the whole restaurant chain. Accordingly, we found that WBB and the Milwaukee area subfranchisees constituted a single integrated business enterprise. This fact along with the fact that there was no economic reason for setting up multiple corporations created a strong inference that the subsidiary corporations were used to syphon off to the subsidiaries income which was earned by WBB. 52 T.C. at 1099. More importantly, WBB was unable to show that the fees that it received from its subsidiaries represented adequate compensation for the services that it rendered the subsidiaries. On these grounds, we held that respondent was not unreasonable in allocating all of the income and deductions of the subsidiaries to WBB.

A large part of our opinion in *Marc's Big Boy* was devoted to detailing the integration of the Milwaukee area Big Boy restaurants as a single business enterprise; however, we believed that it was clear that we were not using section 482 to penalize the petitioners merely for operating a single business through several corporations but to reflect the fact that subsidiaries were being used to distort the amount of income reported by WBB. The operation of a single business through several corporations creates a likelihood that subsidiaries will be used either to permit the parent to evade taxes or to understate its income. We believed that without evidence that the parent and its subsidiaries dealt at arm's length with each other this likelihood formed a reasonable basis for the Commissioner's allocation under section 482. 52 T.C. at 1099. Accordingly, the allocation to WBB was sustained not because there was an integrated business but because there was no proof that WBB and its subsidiaries dealt at arm's length.

With differences that we shall discuss *infra*, the Your Host Restaurants constituted as much of a single integrated business enterprise as did the Milwaukee area Big Boy chain; however, approval of respondent's allocation under section 482 is not ineluctable.

We note that in several respects the restaurant corporations in this case were more viable economically than were the restaurant subsidiaries in *Marc's Big Boy*. All of the corporations paid directly most of their own costs of doing business. These costs included supplies purchased from Sher-Del, utility bills, Federal and state income taxes, social security taxes and income taxes withheld from employees, fire insurance, and license fees. More importantly, each corporation paid the rent for the locations on which it operated restaurants and was solely responsible for it. Your

Host did not guarantee payment of the rent for any locations except its own, and landlords were apparently willing to rely upon the financial responsibility and resources of each corporation rather than those of the total enterprise.

We are also convinced that the fact that Your Host obtained master policies for public liability insurance and workmen's compensation for reasons of economy and administrative convenience does not detract from the fact that each corporation paid its appropriate share of the cost of these items. We think that the situation of Your Host with respect to these expenses is different from that of WBB in *Marc's Big Boy*. WBB operated no restaurants of its own and its only activities were related to running the restaurants owned by its subsidiaries. Hence, it would be impossible to distinguish between WBB's obtaining insurance for its subsidiaries and its providing every other management service for them. On the other hand, Your Host operated as many as 15 restaurants of its own. It incurred no expense in obtaining insurance for the other corporations and benefited from the reduced rates which were available when a larger number of restaurants were insured on the same policy.

Each of the corporations in effect paid the salaries for its own nonadministrative employees. Your Host did no more than lend its name to the "Zero balance" account from which these employees were paid. Your Host did not advance its own funds to pay salaries from this account but only contributed the net salary of its own employees as did the other corporations. The service charges by the bank for the "Zero balance" account were apportioned among the corporations along with other administrative expenses.

The main point of contention between the parties is whether the 15 corporations shared the same admin-

istrative staff and maintenance crew or whether Your Host provided for a fee administrative and maintenance services. Under either theory respondent contends that the amounts paid by corporations for these services were computed under an arbitrary and ever-changing formula. We think it immaterial that the corporations may have used a different formula in other years because those years are not before us. During the years before us the cost of providing administative and maintenances services for all corporations was generally apportioned according to gross sales. Respondent did not determine that this method was unreasonable and we believe it to be based reasonably upon economic realities. We also find it reasonable that advertising expenses and the costs attributable to the district supervisors and maintenance men were only apportioned among the corporations which could benefit from these expenditures. In fact, to have apportioned otherwise would have distorted the income of the non-benefiting corporations.

The only deviations from the allocation based on gross sales involving a corporation whose case is before us is an adjustment for Sher-Del and the apportionment of the salary paid Durrenberger. The accountant for all of the corporations testified that sales between Sher-Del and its sister corporations did not involve as much administrative effort as did sales to outside customers. Accordingly, he felt that it was necessary to reduce the amount of Sher-Del's gross sales for purposes of making the administrative expense allocation. From his testimony and other evidence in the record we find that the adjustments made were reasonable.

Durrenberger received about 40 percent of his total salary from Sher-Del, a fact which is explained by his background and expertise in the provisions busi-

ness. The remainder of his salary was contributed by the other corporations. In the case of the restaurant corporations the amount paid appears roughly to reflect the business activity and number of restaurants of each corporation.

In our opinion petitioners have demonstrated that each corporation paid its own way and that they were economically viable business entities. We are convinced that except for *de minimis* items like help-wanted ads Your Host bore no more of the administrative burden for the restaurant chain than could be accounted for by its own sales. Your Host provided no service for the other corporations for which it was not adequately compensated. Accordingly, unless Your Host could have commanded all of the profits of the other restaurant corporations for the use of its trademark and goodwill, we believe that respondent's allocation is unreasonable for failing to allocate any part of the profits to the corporations which earned them through their own efforts and expense. We emphasize again that the purpose of section 482 is not to punish the existence of multiple corporations but to require each corporation to report its true income.

The trademark and goodwill possessed by Your Host differ considerably from those of WBB in *Marc's Big Boy* and of the downtown store corporation in *Hamburgers York Road, Inc.* First, the restaurants operated by Your Host were on the average no older or more well established than those operated by the ten other restaurant corporations. The restaurants operated by the ten other corporations did not trade upon goodwill generated by the restaurants run by Your Host; all of the restaurants generated goodwill which was shared by all of them equally. The public did not associate a particular restaurant with the corporation that operated it, and it makes as much sense to assume that the ten restaurant corporations donated

goodwill to Your Host as it does to assume that Your Host donated goodwill to the other ten. Therefore, the situation is obviously different from that which obtained in *Hamburgers York Road, Inc.* where the success of the suburban store depended largely upon the public's belief that it was a branch of the old and respected downtown store. Second, be believe that the Your Host trademark had little value in addition to the goodwill generated from the operation of the restaurants themselves. The Your Host trademark cannot be compared to the Big Boy trademark in Marc's Big Boy which was used nationally and which permitted the Milwaukee area restaurants to benefit from the goodwill generated by others across the country. Although Your Host owned the trademark, the concept of Your Host Restaurants really belonged to Wesson and Durrenberger who could donate their idea to their corporations. Without doubt there was an advantage to being a Your Host Restaurant rather than another short order cafe; however, we feel that this advantage flowed primarily from the local advertising and management shared by all of the corporations. We have already determined that the corporations divided up these items equitably. The near failure of the Rochester Your Host Restaurants, which had absentee management problems, indicated that without the concentrated local advertising and local management the Your Host name was not worth a great deal.

We hold in light of the record in this case that the ten restaurant corporations were viable economic entities which earned their own income and that Your Host provided no service or benefit to those ten corporations for which it was not adequately compensated. Accordingly, we hold that respondent may not allocate to Your Host, Inc., all of the income and deduc-

tions of the ten restaurant corporations for the years in issue.[4]

While we believe that the ten restaurant corporations were economically viable, this opinion does not hold true in the cases of Chef, the vending machine corporation, and Bakery.

All of Chef's income was derived from renting refrigeration and storage facilities to Sher-Del and from operating vending machines which were located solely in Your Host Restaurants. There is nothing in the record which indicates whether the terms upon which Chef dealt with its parent, Sher-Del, or its sister corporations were fair and reasonable. Chef, in substance, conducted no business; therefore, it was reasonable for respondent to determine that it did not earn its income. Accordingly, we hold that respondent did not abuse his discretion in allocating all of Chef's income and deductions to Your Host under section 482.

We view the operations of Bakery in a similar light. Bakery only sold its products to Sher-Del; it could hardly be considered to have conducted any business. In addition, Sher-Del paid Bakery the same prices for its products as Sher-Del charged the restaurants. This arrangement garnered for Bakery all of the profit from the manufacture and sale of baked goods. We believe that respondent proceeded upon a reasonable basis in allocating all of Bakery's income

[4] The parties have proceeded upon an all-or-nothing approach with respect to section 482. A partial allocation under section 482 was not among the several alternative resolutions of this case presented by the parties. Accordingly, we do not think that a partial allocation, the basis of which is not readily apparent from record would be appropriate in this case. *Cf. Marc's Big Boy-Prospect, Inc., supra* at 1105–6. *Helvering* v. *Taylor*, 293 U.S. 507 (1935).

and deductions to Sher-Del under section 482 and uphold his determination.

Although we have found that the ten restaurant corporations earned their own income and reported it correctly for purposes of section 482, it does not follow that every one of this host of corporations is entitled to the surtax exemption provided by section 11(d). Respondent contends that the principal purpose for forming the ten restaurant corporations was to obtain additional surtax exemptions and that section 269(a) is applicable to disallow these benefits. We agree with respondent with respect to 309 Delaware, Royal, Main, Telesnax, and Alro only.

Section 269 provides the following in part:

> SEC. 269. ACQUISITIONS MADE TO EVADE OR AVOID INCOME TAX.
>
> (a) IN GENERAL. —If—
>
> (1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or
>
> (2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,
>
> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not

> otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

It is well established that the formation of a new corporation is an acquisition for purposes of section 269. *James Realty Company* v. *United States*, 280 F. 2d 394 (C.A. 8, 1960). We have also held that section 269 applies to an acquired corporation as well as an acquiring corporation. *Concord Supply Corporation*, 37 T.C. 919 (1962). On the facts in this case there is no dispute that the requisite control is present. Accordingly, the only question remaining under section 269 is whether the corporations were formed for tax avoidance purposes.

Respondent has pointed to several facts as ruling out all nontax-avoidance purposes for forming the ten corporations. These facts include the integration of the ten corporations into a single business, the thin capitalization of the corporations, and the frequent interest-free loans and advances among the corporations which were not evidenced by notes. In addition, respondent finds no business reason in his view of the record which justifies the existence of more than one corporation. *Concord Supply Corporation, supra; Joe (Joseph) Dillier*, 41 T.C. 762 (1964), affd. sub nom. *Made Rite Investment Co.* v. *Commissioner*, 357 F. 2d 647 (C.A. 6, 1966). Petitioner, on the other hand, has attempted to show the economic reasons underlying the formation of each corporation. *Southeastern Can-*

teen Co. v. *Commissioner*, 410 F. 2d 615 (C.A. 6, 1969), certiorari denied 396 U.S. 833 (1969).

We believe that the facts noted by respondent are strong circumstantial evidence that tax avoidance was a principal purpose in the formation of the ten corporations. We also tend to discount petitioner's claim that the corporations were set up solely on the advice of their attorney who was an expert in real estate matters without any knowledge of taxation. The benefit of multiple surtax exemptions is, we believe, as obvious to a layman as it is to a tax expert.

Throughout the trial and on brief petitioners have complained that their burden of proof under section 269 is impossible because the corporations were formed from 13 to 22 years before trial and because the principals involved in developing the Your Host Restaurant chain were either dead or unavailable for trial. We sympathize with petitioners and have allowed them great latitude in submitting evidence concerning the formation of the restaurant corporations. We also note that respondent's ability to rebut evidence of purpose has not improved with the passage of time. More importantly, the existence of a principal non-tax-avoidance purpose for forming the corporations can better be proven with evidence of objective facts rather than with subjective evidence of intent provided by the principals. *Bobsee Corporation* v. *United States*, 411 F. 2d 231 (C.A. 5, 1969). Petitioners have brought forth such evidence in the cases of Boulevard, Niagara, Transit, and Sharlem (the shopping plaza corporations) and in the cases of Utica and Rochester.

We believe that the risks involved in the mid-1950's in opening up restaurants in the emerging new suburban shopping plazas on long-term leases justified the formation of separate corporations. The chance of failure in these locations was substantial and formed

the principal motivation for the formation of Boulevard, Niagara. Transit, and Sharlem. The first of these corporations, Boulevard, was formed in 1953 and the last, Sharlem, in 1956 before it became apparent that the shopping plazas were desirable locations. We must lend credence to petitioners' contention that the riskiness of being a pioneer in shopping plaza development was the primary purpose for the formation of the four corporations because following the success of the first plaza locations additional plaza locations were opened without the use of additional corporations.

Utica was formed in 1954 to operate a restaurant in a location upon which a former restaurant proprietor had failed. The restaurant was also in a neighborhood which the partners felt was incompatible with the kind of people who patronized Your Host Restaurants. We believe that the previous record of failure and the problems in the neighborhood in which the restaurant was to be located were the principal factors which motivated the partners to form Utica.

Rochester was incorporated in 1956 to begin developing a chain of Your Host Restaurants in the Rochester area. The problems involved in operating restaurants 70 miles distant from Your Host's normal base of operations were in our opinion substantial. The partners' principal purpose in forming Rochester was to protect their enterprise from the significant risk of losses from the Rochester operation. The partners' fears about the potential for failure in Rochester turned out to be justified in fact as two of the three restaurants opened there failed while the third is barely profitable.

We have examined the reasons offered by petitioners for the formation of the other four restaurant corporations and have found them to be either fantastic

or merely unsupportable upon the record. We have set forth these reasons in detail in the findings of fact. Quite predictably petitioners have argued that the partners wished to limit their liability when opening up new locations even when there was no particular reason for believing that the new location would be unsuccessful. Petitioners have also claimed that several of the corporations were necessary to protect the various Host names from appropriation. Because the creation of any corporation will provide its shareholders with limited liability and prevent another corporation from getting a charter under the same name, we cannot take these arguments too seriously unless there is additional evidence showing the need for multiple corporations.

In light of the strong circumstantial evidence of intent to evade taxes provided by the existence of an integrated business, the thin capital structure and intercorporate borrowing, and the absence of believable business reasons for their formation, we find that the principal purpose for the formation of 309 Delaware, Royal, Main, and Telesnax was tax avoidance. Similarly, there is no reason evident upon the record other than tax avoidance that explains the formation of the real estate holding company, Alro, in 1951. Therefore, we find that the principal purpose for the partners' creation of Alro was tax avoidance.

Accordingly, we hold that respondent was correct in disallowing the surtax exemptions of 309 Delaware, Royal, Main, Telesnax, and Alro.

In light of the foregoing.

Decisions will be entered under Rule 50.

APPENDIX B

United States Court of Appeals for the Second Circuit

Nos. 242–268—September Term, 1973

(Argued October 18, 1973; decided December 11, 1973)

Dockets Nos. 73–1311—73–1337

YOUR HOST, INC., ET AL., PETITIONERS-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

CHEF FOODS, INC., ET AL., PETITIONERS-APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT APPELLANT

Before KAUFMAN, Chief Judge, LUMBARD and TIMBERS, Circuit Judges

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Appeal from judgments of the United States Tax Court (Irwin, *J.*) in consolidated cases in which the Tax Court upheld determinations by the Commissioner, pursuant to 26 U.S.C. §§ 482 and 269, of in-

come tax deficiencies for 1965 through 1968 regarding seven of petitioners-appellants' affiliated corporations.

Affirmed.

RALPH J. GREGG,

Buffalo, New York (Albrecht, Maguire, Heffern & Gregg, and George M. Zimmerman, on the brief), Attorneys for Your Host, Inc., et al., Petitioners-Appellants and Chef Foods, Inc., et al., Petitioners-Appellees.

WILLIAM A. FRIEDLANDER,

Washington, D.C. (Scott P. Crampton, Assistant Attorney General, Ernest J. Brown and Richard S. Halberstein, Attorneys, Tax Division, Department of Justice, Washinggton, D.C., on the brief), Attorneys for Commissioner of Internal Revenue.

LUMBARD, *Circuit Judge:* Petitioners-appellants, Your Host, Inc., and its affiliated companies, appeal from judgments of the United States Tax Court (Irwin, J.) which upheld determinations by the Commissioner of income tax deficiencies assessed for the years 1965 through 1968. *Your Host, Inc., et al.*, 58 T.C. 10 (1972). The deficiencies were assessed pursuant to 26 U.S.C. § 482, which allows the Commissioner to allocate income among affiliated companies more properly to reflect the earning of income,[1] and

[1] 26 U.S.C. § 482 provides: "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

pursuant to 26 U.S.C. § 269, which permits the Commissioner to deny tax exemptions and deductions where an affiliated company was "acquired" for tax avoidance purposes.[2] We affirm.

Your Host, Inc., and its affiliates, operate a restaurant chain and food business in the Buffalo area. From modest beginnings in a one-restaurant partnership of A. J. Durrenberger and R. T. Wesson in 1944, the business grew so that by the mid 1960's it consisted of sixteen interrelated corporations which operated some forty "Your Host" restaurants, a food supply commissary, a bakery, a real estate holding company, and a vending machine and leasehold operation.[3]

[2] 26 U.S.C. § 269 provides in relevant part:

"(a) In general.—If—

"(1) any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation, or

"(2) any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation, not controlled, directly or indirectly, immediately before such acquisition, by such acquiring corporation or its stockholders, the basis of which property, in the hands of the acquiring corporation, is determined by reference to the basis in the hands of the transferor corporation,

and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary or his delegate may disallow such deduction, credit, or other allowance."

[3] The principal corporations among the group were Your Host, Inc., the original company begun as a partnership in 1944 and incorporated in 1947 and which now operates fifteen "Your Host" restaurants, and Sher-Del-Foods, Inc., also incorporated in 1947, which owns and runs the food processing part of the business. In addition to these two principal companies, there are ten subsidiaries and affiliates which run "Your Host" restaurants: 309 Delaware Ave., Inc. (four restaurants), Royal Host,

All of these enterprises remained under the control of two original partners and later, after Wesson's death in 1956, under the control of Durrenberger alone.

Out of the sixteen companies the Commissioner, pursuant to 26 U.S.C. § 482, allocated the income of twelve of them to Your Host, Inc.[4] and the income of one of them (Your Host Bakery, Inc.) to Sher-Del Foods, Inc. He furthermore determined that, pursuant to 26 U.S.C. § 269, thirteen of the companies had been established for the principal purpose of tax avoidance and he accordingly denied them the corporate surtax exemption.[5]

Upon review the Tax Court upheld the Commissioner's determinations under § 482 as to only two of the affiliated companies: the allocation of Chef Foods' income to Your Host, Inc., and the allocation of Your Host Bakery's income to Sher-Del Foods, Inc. The Tax Court held that the ten restaurant operating companies whose income had been allocated were "viable economic entities which earned their own income" and hence were not subject to income allocation.

Inc. (one), Boulevard Host, Inc. (two), Utica Host, Inc., (four), Niagara Host, Inc. (four), Main Host, Inc. (three), Transit Host, Inc. (two), Sharlem Host, Inc. (three), Rochester Host, Inc. (originally three, now one), and Telesnax, Inc. (one). There is also Air Host, Inc., which runs the business's one "Royal Host" restaurant. The remaining three companies are Your Host Bakery, Inc. (supplier of bakery goods to the business), Chef Foods, Inc. (a subsidiary of Sher-Del which handles vending machine operations and which leases storage facilities to Sher-Del and Your Host Bakery), and Alro Realty, Inc. (another subsidiary of Sher-Del which owns the principal business property of Sher-Del and Your Host).

[4] These were the ten companies (aside from Your Host, Inc.) which operated "Your Host" restaurants (see fn. 3), plus Air Host, Inc., and Chef Foods, Inc.

[5] These were again the ten companies operating "Your Host" restaurants, plus Chef Foods, Inc., Your Host Bakery, Inc., and Alro Realty, Inc.

The Tax Court also upheld the Commissioner's determination under § 269 as to five of the affiliated companies: 309 Delaware Ave., Inc., Royal Host, Inc., Main Host, Inc., Telesnax, Inc., and Alro Realty, Inc. With respect to the other eight companies which had been denied surtax exemption, however, the court held as to six that the Commissioner had erred in finding that they had been established for the principal purpose of tax avoidance. The court did not assess the validity of the Commissioner's § 269 determinations as to Chef Foods and Your Host Bakery, having already sustained the Commissioner's 100% reallocation of the income of both companies under § 482.

Since the Commissioner has elected not to appeal the Tax Court's finding adverse to the government,[6] we need concern ourselves here only with the Tax Court's findings[7] sustaining the Commissioner's determinations. As to these we note at the outset that the Commissioner's determinations are to be set aside only if "unreasonable, arbitrary, or capricious," in the case of § 482 allocations, *Wisconsin Big Boy Corp.* v. *C.I.R.*, 452 F. 2d 137, 140 (7th Cir. 1971); *Philipp Bros. Chemicals, Inc.* v. *C.I.R.*, 435 F. 2d 53, 57 (2d Cir. 1970), and only if "clearly erroneous" in the case of denials of surtax exemptions under § 269, *Dorba Homes, Inc.* v. *C.I.R.*, 403 F. 2d 502, 505 (2d Cir. 1968); *J. T. Slocomb Co.* v. *C.I.R.*, 334 F. 2d 269, 273–74 (2d Cir. 1964).

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[6] The Commissioner has filed a protective cross-appeal requesting that, in the event we reverse the Commissioner's § 482 determinations as to Chef Foods and Your Host Bakery, we remand to the Tax Court for consideration of the Commissioner's § 269 determinations with respect to both companies. Since we affirm the decision below, we need not consider this cross-appeal.

[7] We have not thought it necessary to recount all the findings of the Tax Court since they are set out in detail in its opinion, 58 T.C. 10 (1972).

Under these standards of review, we cannot say that the Commissioner's § 482 determinations were arbitrary or unreasonable. In the case of Chef Foods, Inc., whose income was allocated to Your Host, Inc., for the four years in question, it was found that Chef Foods was originally formed in 1958 to provide a vehicle for developing catering services in industrial plants. This line, however, was never developed. Instead Sher-Del Foods acquired all the stock of Chefs Foods for $6,000. Chef Foods was then used to purchase cigarette vending machines which were placed only in "Your Host" restaurants. It purchased cigarettes wholesale and sold them through vending concessions at the restaurants, the profits being shared through concession commissions to each restaurant. Chef Foods also acquired refrigeration and storage facilities in Buffalo, almost all of which were leased to Sher-Del Foods and to Your Host Bakery. For these operations, Chef Foods utilized one employee, a vending machine repairman, whose salary and expenses constituted virtually all of the operating expenses of the company. Otherwise Chef Foods shared its aliquot portion of taxes, insurance, utility, and other costs along with the other corporations as summarily determined by the common executive management of the companies. The portion of Chef Foods' profit which Durrenberger, then the surviving original partner, took as his salary was also similarly determined. Chef Foods' income from the vending machine sales and from rents averaged roughly $160,000 for each year between 1965 and 1968, with approximately 75% coming from the vending machines sales. Thus while it is true, as the dissent suggests, that Chef Foods conducted sizable business operations in terms of cash flow, the very imbalance between the firm's posture on its balance sheets and the actual scope of its operations, in terms of its labor force, capitaliza-

tion, work site, and so forth, suggests that the firm was kindred in nature to the kind of sham enterprise which this court held properly subject to income allocation in *Philipp Bros. Chemicals, Inc.* v. *C.I.R., supra.* At least, given Chef Foods' position within the "Your Host" group, it was not unreasonable for the Commissioner to have allocated the income of Chef Foods as he did. See also *Wisconsin Big Boy Corp.* v. *C.I.R., supra;* and *Hamburgers York Road, Inc.,* 41 T.C. 821 (1964).

For the same reasons we are constrained not to disturb the Commissioner's allocation of the income of Your Host Bakery, Inc., to Sher-Del Foods, Inc. The bakery sold its products only to Sher-Del. Sher-Del in turn sold these products to the various "Your Host" restaurants but at the same price at which it had bought them. The entire profit of the baking part of the enterprise thus went to the bakery even though Sher-Del Foods was the seller to the rest of the chain. In addition, although the bakery did employ a sizeable work force (unlike Chef Foods), it did share the same top-level management as Your Host, Inc., and Sher-Del Foods, Inc., with similar apportionment of salaries and expenses. Furthermore, it shared the same premises with Sher-Del Foods.

Although not conceding the point, appellants contend that under these circumstances the Commissioner was at best entitled to allocate the bakery's income to Sher-Del only to the extent of determining a reasonable profit to Sher-Del for its services in distributing the bakery's products to the "Your Host" chain. The dissent endorses this position, and cites in support of it language in our decision in *W. Braun Co.* v. *C.I.R.,* 396 F. 2d 264 (2d Cir. 1968). However, in view of the highly integrated nature of the business enterprise, we do not believe that it was unreasonable for the

Commissioner to have concluded that all of the bakery's income should be attributable to Sher-Del. As we said in the later case of *Philipp Bros. Chemicals, Inc.* v. *C.I.R., supra,* at 59:

> [T]he taxpayer had the burden of showing that the 100% allocation of income to the [parent] corporation was unjustified. Taxpayers ask us to remand the case in order to allow them an opportunity to establish that the 100 per cent allocation was unreasonable and to show what a reasonable allocation would be. We see no reason for according them another chance. * * *

The petitioners here having similarly failed to demonstrate the reasonable allocation which they claim was their due, we believe our position as stated in the *Philipp* case is controlling. See also *Wisconsin Big Boy Corp.* v. *C.I.R., supra,* at 140; *Ballentine Motor Co.* v. *C.I.R.,* 321 F. 2d 796 (4th Cir. 1963); *Hall* v. *C.I.R.,* 294 Fd 2d 82 (5th Cir. 1961).

The Commissioner's determinations under 26 U.S.C. § 269, to disallow the surtax exemption for five of the appellants' corporations, were also within permissible limits.[8] We note that four of these five (Telesnax, Inc., Royal Host, Inc., Main Host, Inc., and 309 Delaware Ave., Inc.) were merely alternate vehicles for operating additional "Your Host" restaurants. They were all thinly capitalized. They were all financed by substantial loans from Your Host, Inc., and from Sher-Del Foods, Inc., loans either not evidenced by notes or established through a system of delayed billing. More importantly, in none of these four instances

[8] There is, of course, no longer any question that the formation of a new corporation can be an acquisition for the purposes of § 269. *James Realty Co.* v. *United States,* 280 F. 2d 394 (8th Cir. 1960), and also that § 269 applies to an acquired corporation as well as to an acquiring corporation, *Concord Supply Corp.,* 37 T.C. 919 (1962).

were the appellants able to proffer reasons for their separate incorporation other than a desire to limit liability for its own sake (which is in any event a necessary consequence of incorporation) and, in the case of Telesnax, the additional desire to give Wesson and Durrenberger's accountant a capital share in the business. Unlike the situation regarding the six "Your Host" companies where the Tax Court found the principal purpose of incorporation to have been other than tax avoidance, for these four restaurant operating corporations the appellants cited no unusual risks incumbent on the ventures, such as location in an untried shopping center development or in a community with strong pre-established competition, nor any other factors, such as the need to protect a corporate name not already protested or to protect the goodwill of a particular restaurant, which might have been persuasive of the necessity for separate incorporation,[9] Accordingly, the Commissioner's conclusion that tax avoidance was the principal purpose behind their separate incorporation was not "clearly erroneous." See *Scroll, Inc.* v. *C.I.R.*, 447 2d 612 (5th Cir. 1971); *Bobsee Corp.* v. *United States*, 411 F. 2d 231 (5th Cir. 1969); *Borge* v. *C.I.R.*, 405 F. 2d 673 (2d Cir. 1968).

Although incorporated for reasons other than operating a "Your Host" restaurant, Alro Realty, Inc., presents no different considerations in regard to the Commissioner's disallowance of its surtax exemption. Appellants argued before the Tax Court that the principal purpose for establishing Alro was to facilitate

[9] The circumstances which the dissent urges as justifying the separate incorporation of 309 Delaware Ave., Inc., for example the slightly higher rent, the smaller number of pedestrians, and so forth, are marginal at best. These factors are not equivalent to such substantial risks as taking on established competition or beginning business operations in a city where the "Your Host" name was generally unknown.

real estate mortgage financing for the overall enterprise. Yet, the operation of Alro subsequent to its formation undercuts that contention.

Alro was created by Wesson and Durrenberger in 1951 with a capitalization of $2,000. It then purchased all of Sher-Del Foods' business real estate, including the commissary building, by delivering promissory notes totalling $112,822.93, but failed to assume Sher-Del's prior mortgage obligation. Moreover, although Alro has repaid a mere $3,000 on these notes, Sher-Del has continued making capital advances to Alro. In sum, Alro has never been utilized as a financing vehicle or in any other manner to improve the working capital position of its parent, Sher-Del, or its affiliate, Your Host, Inc. On these facts the Commissioner was not clearly erroneous in determining that Alro was established for the principal purpose of tax avoidance. See *Bobsee Corp.* v. *United States, supra,* at 238; *Dorba Homes* v. *C.I.R., supra,* at 505–506.

The only troublesome point which remains concerns the apparent inconsistency of the Tax Court's conclusions under §§ 482 and 269. The four restaurant operating corporations of the "Host" group which have been denied the surtax exemption because of their "acquisition" for the principal purpose of tax avoidance were also found, however, to have "sound business reasons" for their separate corporate existence, so that as to them the Tax Court reversed the Commissioner's income allocations under § 482. This apparent inconsistency is resolved by the fact that a company may operate from day to day as a valid economic entity although it may have originated as a tax avoidance device. Sections 482 and 269 of the Code look to different periods in a corporation's existence, as they also look to different elements of proof: economic reality in reference to income versus inference of intent in reference to tax savings. Thus

even though the establishment of these elements requires in part the assessment of common facts in the conduct of a company after its "acquisition," the purposes relevant to such assessment may be quite distinct. In a case very similar to the present one, this court cautioned against

> confus[ing] "a purpose," the continued existence of which may be enough to eliminate [an adverse determination under § 482], with "the principal purpose" to evade or avoid the Federal income tax, the intial presence of which governs § 269 and which may exist alongside other secondary reasons for the formation of the corporation.

Dorba Homes, Inc. v. *C.I.R.*, *supra*, at 506. That caution is no less applicable to the facts of the instant case.

We find no merit in the appellants' final contention that the application by the Commissioner of the sanctions of § 269 "so many years after the fact" is a violation of the due process clause.

The judgments of the Tax Court are accordingly affirmed.

TIMBERS, *Circuit Judge* (dissenting in part): Since I am disturbed by certain inconsistences in the Tax Court decision and by the majority's placing the imprimatur of our Court on those inconsistencies, I respectfully dissent in part.

With respect to the Section 482 allocations, I dissent from the majority opinion to the extent that it affirms the Tax Court in upholding the Commissioner's allocation of Chef Foods' income to Your Host and his allocation of the entire income of Your Host Bakery to Sher-Del Foods. As to the Chef allocation, I would reverse. As to the Bakery allocation, I would reverse, and remand for determination of a proper adjustment and a reallocation of income.

With respect to the Section 269 surtax exemptions, I agree with the majority's affirmance of the Tax Court in upholding the Commissioner's disallowance of surtax exemptions for four of appellant's five affiliated companies. As to the 309 Delaware restaurant, however, I would reverse and hold that the Commissioner's disallowance of its surtax exemptions was clearly erroneous.

I

Section 482 of the Internal Revenue Code of 1954, 26 U.S.C. § 482 (1970), authorizes the Commissioner to "allocate gross income" among the units of commonly controlled business organizations. Its purpose is to prevent tax evasion or clearly to reflect the income of the various parts of an integrated corporate group. While this statute gives the Commissioner broad discretion to allocate income, it does not permit him to disregard a separate corporate entity if it exists for "a bona fide business purpose", *W. Braun Co.* v. *C.I.R.*, 396 F. 2d 264, 268 (2 Cir. 1968), and if it conducts substantial business activities and earns its own income. *Philipp Brothers Chemicals, Inc.* v. *C.I.R.*, 435 F. 2d 53 (2 Cir. 1970). Nor does this statute permit the Commissioner to substitute his business judgment for that of management. The fact that a parent corporation might have performed services for itself rather than establishing a subsidiary for that purpose is irrelevant so long as the latter is a viable, going concern. *Philipp Brothers Chemicals, Inc.* v. *C.I.R.*, *supra*, 435 F. 2d at 58. Income allocation is proper only when the income earned by one corporation is artificially deflected to another.[10]

[10] See 7 Mertens Law of Federal Income Taxation § 38.63 (Zimet & Barton rev., 1967): "The identity of businesses is to be preserved and the Secretary or his delegate has no authority under [§ 482] to merge them into one single business

Applying these criteria to the instant case, the Tax Court held that the ten restaurant corporations were "economically viable business entities". 58 T.C. at 27. It refused to uphold the Commissioner's allocation of their income to Your Host. The Tax Court based its conclusion on the fact that these corporations earned their own income and paid their own costs of doing business.[11]

If the Tax Court was correct in holding such operational autonomy to be a bar to income allocation with respect to the ten restaurant corporations, I fail to understand the majority's conclusion with respect to Chef Foods. Chef was a viable, independently functioning business enterprise. It had cigarette vending machine sales averaging $130,000 per year; it had a salaried employee for whom it paid workmen's compensation and social security contributions; it owned its own vending machines and maintained a substantial inventory; it paid its own utilities, taxes, automobile expenses and, as did the ten restaurant corporations, a proportionate share of group insurance and general administrative costs.[12] Chef conducted its business no differently than did its competitors. It serviced

unless the businesses are carried on and manipulated in such a way as to constitute one single business, or unless the 'controlled enterprise' is a sham." (citations omitted).

[11] Each of the ten restaurant corporations paid for its own non-administrative help, supplies, utilities, state and federal taxes, social security contributions, fire insurance premiums and license fees. Each was solely responsible for payment of its own rent. Each paid a proportionate share of the common administrative and group insurance costs.

[12] The majority notes that Chef had insubstantial business expenses. As long as Chef was a viable enterprise and received no services from Your Host for which the latter was not adequately compensated—i.e. no income distortion—that fact would appear irrelevant.

its own machines, collected receipts and paid commissions based upon the amount of merchandise sold.

These factors clearly distinguish the instant case from *Philipp Brothers Chemicals, Inc.* v. *C.I.R. supra.* There we affirmed the Tax Court in sustaining the Commissioner's allocation of the entire income of foreign sales subsidiaries to their parent upon a finding that they had had no employees, no inventory and did nothing whatever to earn the income they reported. That is a far cry from the situation here.

The case against allocating all of Your Host Bakery's income to Sher-Del Foods is even more compelling. Bakery had sales in excess of $175,000; it had a payroll of approximately $50,000; it purchased more than $80,000 worth of raw materials; and it paid for its own insurance, linen, laundry and operating supplies. These are clear indices of operational autonomy. They demonstrate that Bakery was a viable, income earning enterprise. I see no basis for the Tax Court's conclusion that Bakery "could hardly be considered to have conducted any business." 58 T.C. at 28–29.

True, Bakery sold its entire output through Sher-Del which acted without charge as Bakery's middleman, delivery and billing agent. There was some income distortion. This does not mean, however, that a Section 482 allocation of 100% of the subsidiary's income is appropriate. While Sher-Del has not established the adjustment necessary to reflect the cost to it of these services, it has demonstrated that Bakery earned a substantial portion of its reported income. In an analogous situation, we held that

> "[t]he Commissioner was * * * not justified in arbitrarily allocating *all* of [the subsidiary's] taxable income to petitioner." *W. Braum Co.* v. *C.I.R., supra,* 396 F. 2d at 268. (emphasis added).

I would remand for a determination of the proper adjustment of Sher-Del's costs as a basis for reallocating Bakery's income to Sher-Del according to law.[13]

II

Since Your Host did not demonstrate non-tax avoidance reasons for the separate incorporation of Telesnax, Inc., Royal Host, Inc., Main Host, Inc. and Arlo Realty, Inc., the Tax Court correctly upheld the Commissioner's disallowance of their surtax exemptions pursuant to Section 269 of the Internal Revenue Code of 1954, 26 U.S.C. § 269 (1970).

The specific findings of the Tax Court with respect to 309 Delaware Ave., Inc.,[14] however, establish that it was formed for the very reasons said to have justified the formation of the eight other "Host" companies as to which the Tax Court found the principal purpose of incorporation to have been other than tax avoidance. These findings by the Tax Court strike me as undermining the majority's assumption that there were "no unusual risks * * * which might have been persuasive of the necessity for separate incorporation" of 309 Delaware. I would hold that the Commissioner's disallowance of its surtax exemption was clearly erroneous. See *Borge* v. *C.I.R.*, 405 F. 2d 673 (2d Cir. 1968).

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[13] A proper adjustment would involve an increase in Sher-Del's income sufficient to reflect the cost to it of the billing and delivery services provided for Bakery and a corresponding decrease in Bakery's income.

[14] The Tax Court with respect to the 309 Delaware restaurant: "The prospects for a restaurant at 309 Delaware Avenue were not as favorable as those enjoyed at the other Your Host locations. The rent was higher there than for other locations ($250 to $300 per month over a seven-year period compared to a $200 maximum per month on a ten-year lease at 3232 Bailey Avenue). There were no adjacent parking facilities, and pedestrian traffic was not as heavy as at other locations." 58 T.C. at 14.

APPENDIX C

United States Court of Appeals for the Second Circuit

Nos. 242–268—September Term, 1973

(Argued October 18, 1973; decided December 11, 1973)

Dockets Nos. 73–1311—73–1337

YOUR HOST, INC., ET AL., PETITIONERS-APPELLANTS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

CHEF FOODS, INC., ET AL., PETITIONERS-APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

Before KAUFMAN, Chief Judge, LUMBARD and TIMBERS, Circuit Judges

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Appeal from judgments of the United States Tax Court (Irwin, J.) in consolidated cases in which the Tax Court upheld determinations by the Commissioner, pursuant to 26 U.S.C. §§ 482 and 269, of in-

come tax deficiencies for 1965 through 1968 regarding seven of petitioners-appellants' affiliated corporations.

Affirmed.

RALPH J. GREGG,

Buffalo, New York (Albrecht, Maguire, Heffern & Gregg, and George M. Zimmermann, on the brief), attorneys for Your Host, Inc., et al., petitioners-appellants and Chef Foods, Inc., et al., petitioners-appellees.

WILLIAM A. FRIEDLANDER,

Washington, D.C. (Scott P. Crampton, Assistant Attorney General, Ernest J. Brown and Richard S. Halberstein, Attorneys, Tax Division, Department of Justice, Washington, D.C., on the brief), attorneys for Commissioner of Internal Revenue.

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IN THE

Supreme Court of the United States

No. 73-1687

October Term, 1973

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CHEF FOODS, INC.,

and

YOUR HOST BAKERY, INC.,
Respondents.

REPLY TO PETITION

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IN THE

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No. 73-1687

COMMISSIONER OF INTERNAL REVENUE,
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CHEF FOODS, INC.,

and

YOUR HOST BAKERY, INC.,
Respondents.

REPLY TO PETITION

Statement

Internal Revenue Agents, explaining that their purpose was to disallow the surtax exemptions of fourteen of the sixteen corporations owned by Alfred J. Durrenberger, allocated the net income of thirteen of them (including Chef Foods, Inc.) to the first corporation formed by Mr. Durrenberger (Your Host, Inc., incorporated in 1947) and taxed it there at 48% with the benefit of only Your Host's surtax exemption.

They then allocated all of the net income of Your Host Bakery, Inc. to the second corporation formed by Mr. Durrenberger (Sher-Del Foods, Inc., also incorporated in 1947).

By consolidating the income of fourteen corporations on the tax return of one corporation, they *indirectly* but neatly excised thirteen of the fourteen surtax exemptions. They used § 482 of the Internal Revenue Code as their authority for this. The surtax exemption of Your Host Bakery, Inc. was likewise nullified by the consolidation of its income with Sher-Del Foods, Inc.

To accomplish their purpose one way or another, they cited § 269 in the alternative as their authority for disallowing the surtax exemptions *directly*. The dollar result is exactly the same, of course, whether the income is taxed to thirteen corporations without the benefit of surtax exemptions or to a fourteenth corporation with only one surtax exemption.

They did this for the same reason given for the granting of this Writ—"to protect the revenue"—if they were wrong under § 482 and even though it imposed on the taxpayers the burden of proving the propriety of every major business decision made by Ross T. Wesson and Alfred J. Durrenberger (both deceased) during a 25 year period commencing in 1945.

The Tax Court found that the Commissioner had improperly taxed Your Host, Inc. with the net income of all but Chef Foods, Inc. However, it sustained the § 482 allocation of the net income of Chef Foods, Inc. to Your Host, Inc. and the net income of Your Host Bakery, Inc. to Sher-Del Foods, Inc. Having, in effect, disallowed their surtax exemption by the § 482 allocation, it did not

specifically rule on the § 269 issues as to them. The Second Circuit affirmed.

These findings are now the subject of a petition for a Writ of Certiorari filed by Your Host, Inc., *et al*, in Docket No. 73-1652.

Question Presented

Should this case be remanded to the Tax Court to decide if Chef Foods, Inc. and Your Host Bakery, Inc. should lose their surtax exemptions under § 269 of the Internal Revenue Code? (But only in the event that the Supreme Court should hold that the Commissioner was without authority to use § 482 to disallow the surtax exemptions indirectly).

Whether or not to Grant the Writ

The Respondents do not oppose the granting of this Writ coincidental to the granting of the Writ for which a petition was filed in Docket No. 73-1652. The Trial Court should have an opportunity to rule on the alternative § 269 issue if the Supreme Court should hold that it chose the wrong Section of the Code to disallow Chef's and Bakery's surtax exemption. Actually, the Trial Court made specific findings of fact showing that there were sound and substantial business reasons for the incorporation of both Chef Foods, Inc. and Your Host Bakery, Inc. (Petition, Appendix A, Pages 19-20). It found no facts that even suggest tax motives for their incorporation and Government Counsel has been unable to find or suggest any either.

Respectfully submitted,

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Dated: August 22, 1974.